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KEN FISHER: THE MARKET IS GETTING FROTHY

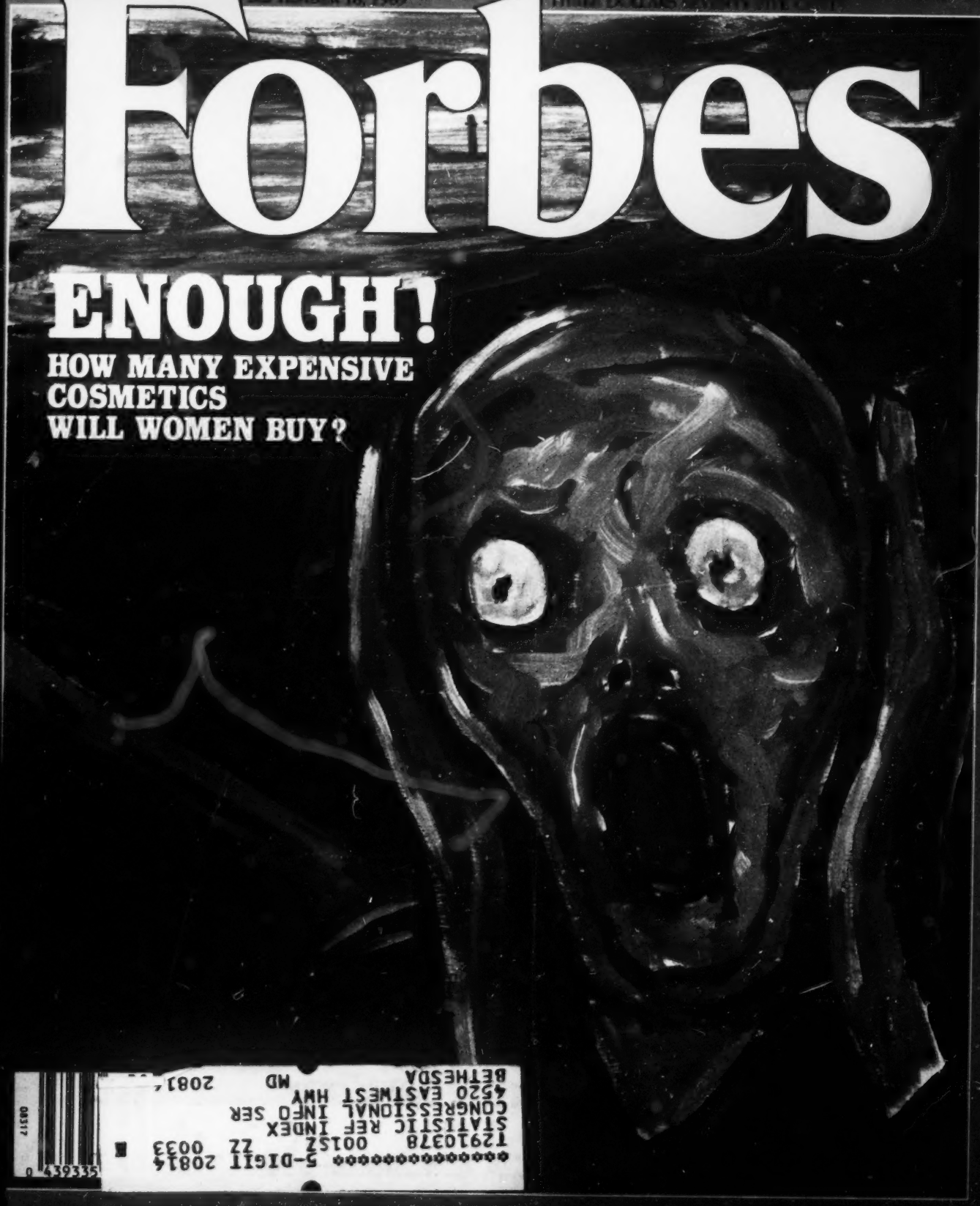
ARE AUTO STOCKS CHEAP?

SEPTEMBER 18, 1989

Forbes

ENOUGH!

HOW MANY EXPENSIVE COSMETICS WILL WOMEN BUY?



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NUMBER 6

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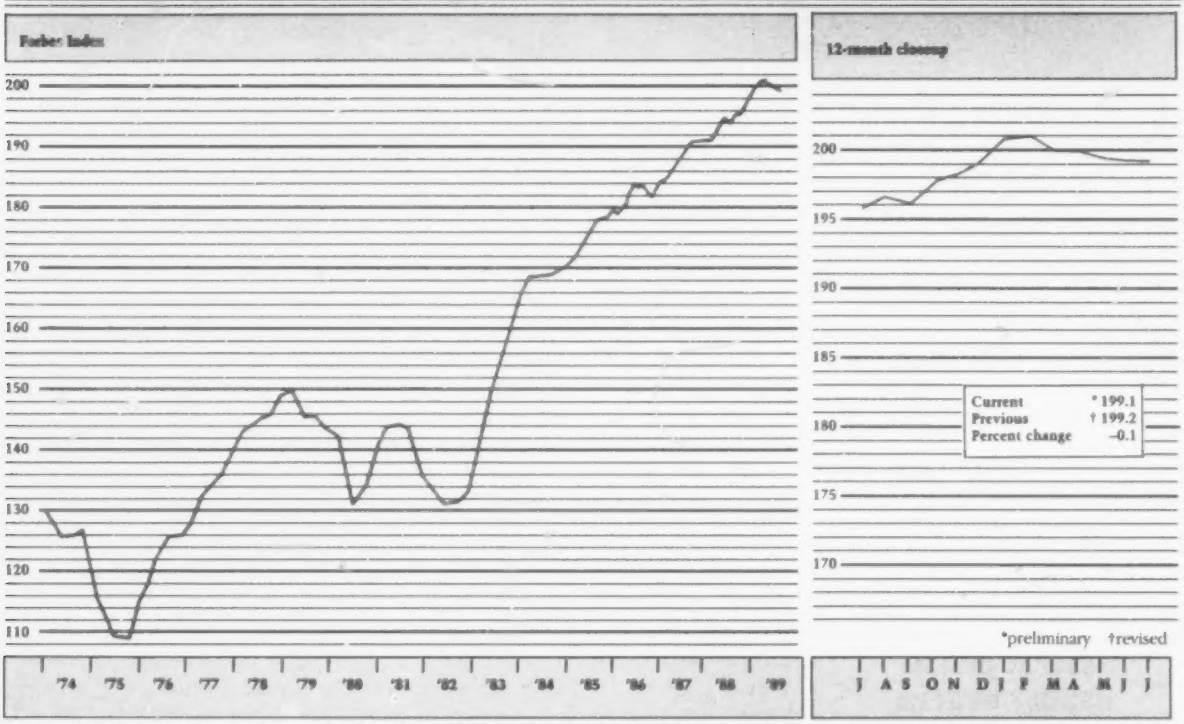
September 18, 1989 Volume 144 Number 6 Forbes (ISSN 0015 6914) is published biweekly except weekly during two weeks in October, by Forbes Inc., 60 Fifth Ave., New York, N.Y. 10011. Second-class postage paid at New York, N.Y. and at additional mailing offices. Canadian second-class postage paid, permit number 9490. Subscription $48 a year, U.S.A. Postmaster: Send address changes to Forbes, 60 Fifth Ave., New York, N.Y. 10011. Copyright © 1989 Forbes Inc. Title is protected through a trademark registration in the U.S. Patent Office.

The Forbes Index



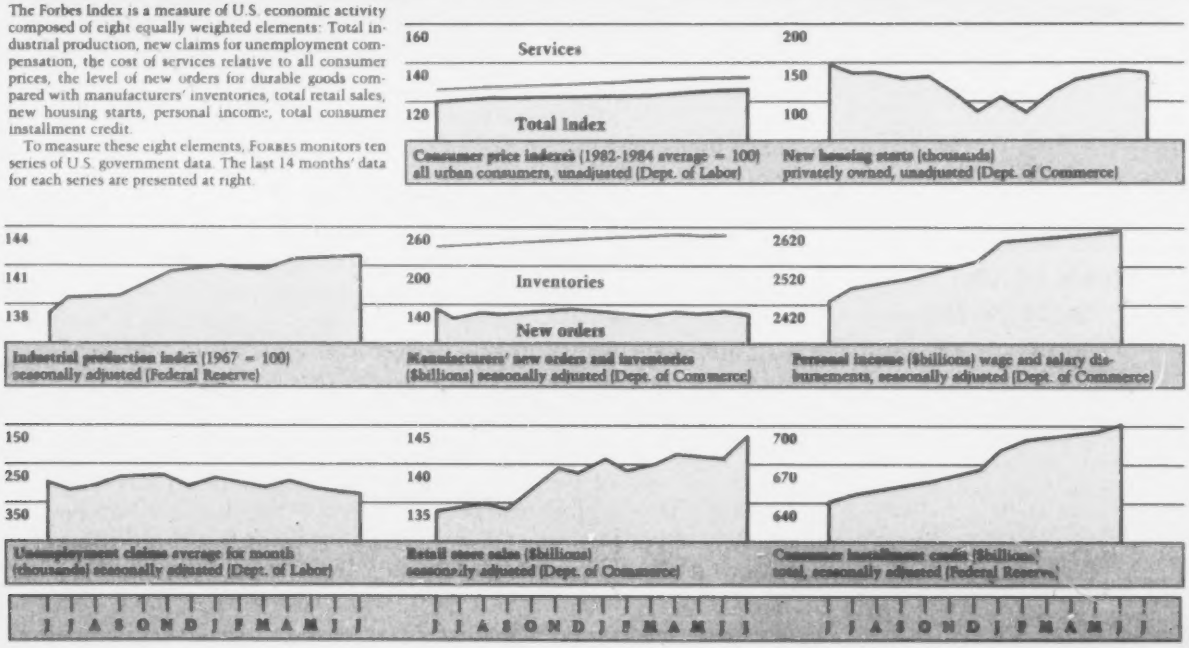
Signs of a slump. The Forbes Index has been falling since March, and preliminary results indicate that the Index fell another 0.1% in July. New unemployment claims jumped over 1% in July, to 339,100, the highest level since January 1988. New housing starts fell 8% in July, the first decline in six months. Slackening auto and machinery demand was in large measure responsible for the 1.9% drop in manufacturers' new orders in July.

There are a few bright spots in the economy. July retail sales were up 2%. Industrial production eked out a 0.2% gain in July. Thanks to soft energy and apparel prices, the overall Consumer Price Index rose only 0.2% in July.

The Forbes Index Components

The Forbes Index is a measure of U.S. economic activity composed of eight equally weighted elements: Total industrial production, new claims for unemployment compensation, the cost of services relative to all consumer prices, the level of new orders for durable goods compared with manufacturers' inventories, total retail sales, new housing starts, personal income, total consumer installment credit.

To measure these eight elements, FORBES monitors ten series of U.S. government data. The last 14 months' data for each series are presented at right.


160
140
120
Services
Total Index
200
150
100
Consumer price indexes (1982-1984 average = 100) all urban consumers, unadjusted (Dept. of Labor)
New housing starts (thousands) privately owned, unadjusted (Dept. of Commerce)
144
141
138
260
200
140
Inventories
New orders
2620
2520
2420
Industrial production index (1967 = 100) seasonally adjusted (Federal Reserve)
Manufacturers' new orders and inventories ($billions) seasonally adjusted (Dept. of Commerce)
Personal income ($billions) wage and salary disbursements, seasonally adjusted (Dept. of Commerce)
150
250
350
145
140
135
700
670
640
Unemployment claims average for month (thousands) seasonally adjusted (Dept. of Labor)
Retail store sales ($billions) seasonally adjusted (Dept. of Commerce)
Consumer installment credit ($billions,' total, seasonally adjusted (Federal Reserve,'
J J A S O N D J F M A M J J
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Most investors think the best investments of the information age lie in Silicon Valley. Would you believe Mexico City or Madrid?

Global phone plays

By Ralph King Jr.

MAKING A telephone call overseas is no longer the white-knuckle experience it used to be. Mirabile dictu, those inefficient monopolies run by post-office bureaucrats in countries like Mexico, Spain and Britain are starting to act a bit more like AT&T.

Many have been auctioned off to private shareholders or deregulated in some degree. They are making huge investments to expand and modernize their networks. They are learning what it means to respond to customer needs, spurred, in some cases, by competition. New technology, such as digital switching, is cutting maintenance costs. Result: The revenue base and earnings of some of the best are growing dramatically.

Suddenly, telephone service is no longer a yawn but a hot investment concept. "Boring old telephone firms are on a breakout," says Douglas Campbell of D.A. Campbell Co., an institutional brokerage based in Los Angeles. "They are becoming highly advanced telecommunications companies. What you get is a technology play à la Silicon Valley, but with safety, because no phone company will be allowed to go under."

Campbell, a 60-year-old globetrotting analyst and investor, has made a tidy fortune with offbeat investment ideas. He sees substantial investment potential in the fact that people in other countries are starting to use the phone the way Americans have for years. Economic activity and phone traffic seem to go hand-in-hand. Network usage in a booming Spain rose 16% during 1988. A 30% surge in foreign calls in and out of Mexico since the beginning of 1989 reflects new life in its long-depressed economy. New technology has also boosted usage: Fax transmissions are estimated to account for up to 50% of traffic between the U.S. and Japan.

Getting the governments out of the business is half the secret of the success. In late 1984, 51% of British Telecommunications Plc. was sold to the public, and management has had to adjust to competition for the first time ever from Mercury Communications, a Cable & Wireless Plc. subsidiary. Telefónica de España, 35% state owned, recently was permitted to charge for maintenance of customer-owned phones, a service that has been free, and unprofitable, for years.

Stock picker Campbell has been tracking foreign phone companies since 1986, as many became available on U.S. exchanges as stocks or as American Depositary Receipts *(see table, p. 196)*. He finds two of them especially attractive.

British Telecommuni-

Darryl Estine/Onyx

Douglas Campbell of institutional brokerage D.A. Campbell Co.
"Boring old telephone firms are on a breakout."

Dialing for dollars

Six of these phone utilities are traded on American exchanges, either directly or as American Depositary Receipts. Cable & Wireless must be bought in London. NTT is for now legally off limits to U.S. investors.

Stock	Recent price	Price/ earnings*	3-year growth†	Dividend yield	Return on equity	Stability rating‡
BCE (Bell Canada)	35⅛	16	7%	5.8%	11.1%	A
British Telecommunications ADR	41¼	9	10	5.1	18.5	A
Cable & Wireless	9⅛	18	13	1.8	24.5	B
Hong Kong Telecommunications ADR	18¼	12	22	2.3	45.0	C
Nippon Telegraph & Telephone	11,329	110	3	0.3	5.9	A
Philippine Long Distance	19⅜	8	12	0.8	27.0	C
Telefónica de España ADR	25⅞	14	9	5.2	5.4	B
Teléfonos de Mexico ADR	0.688	7	33	0.8	8.7	C

*Multiple of estimated 1989 earnings. †Projected growth rate in earnings per share. ‡Country risk ranked according to political and economic conditions. "A" signifies most stable.

Source: D.A. Campbell Co.

cations, one of Europe's largest companies with 1988 sales of $19 billion, is lumbering into the information age. It is gradually replacing antiquated analog wires and switches with digital ones, in which sound waves are converted to the 0s and 1s of computer talk. By 1992 the majority of this work will be complete. A low level of productivity—110 lines per employee, compared with 174 in the U.S.—should improve at that time, Campbell feels, because the new systems are highly automated and require far less maintenance. (Note how the U.S. telephone strike is scarcely noticeable.) Another plus is that unlike the Baby Bells, British Telecom is not subject to a ceiling on its rate of return on invested capital. Instead, prices for service are related to an inflation index, so that shareholders capture much of the productivity gains from newer equipment. British Telecom earns 18.5% on its equity.

Campbell also gives the company high marks for investing excess cash in related businesses. So far this year, British Telecom spent $1.7 billion to get McDonnell Douglas' data communications unit and 20% of McCaw Cellular Communications. On the other hand, BCE Inc., which owns Bell Canada, has diversified into "unexciting" oil and gas pipelines and financial services. Investors perceive British Telecom as more risky than BCE, Campbell notes, but it has a steady 5% yield and bright medium-term prospects. "British Telecom's terribly unpopular. But it has fewer restrictions than it did, and it's still a virtual monopoly," he says.

Teléfonos de Mexico is Campbell's favorite of all the phone stocks, despite Mexico's economic and social problems. The company has been adding access lines at an 8% annual clip. That growth is possible largely because it gets about half its revenues in dollars from foreign calls, mostly with the U.S.; this has shielded it somewhat from a weak currency and raging inflation. One problem: It hasn't been able to collect on payphone calls for years. Why? The machines would be full of Mexico's nearly worthless coins after a few calls.

Teléfonos, recently at 69 cents per share, has been as erratic as the rest of Mexico's Bolsa. Still, Campbell says it's cheap on several counts. It trades over-the-counter at just 7 times projected 1989 earnings, versus 13 for the slow-growth Baby Bells. Its market capitalization per access line is just $582, against an average $1,225 for the Bells. Unlike other rapidly expanding firms like Telefónica de España, which have diluted outstanding shares with a string of discounted new issues, the Mexican company has financed its recent growth internally and by issuing new shares at a premium to the market price. Though it pays only a minor dividend, Teléfonos will get a big earnings kicker if the government, with a 51% stake, refunds up to $800 million in 1989 taxes, a move Campbell thinks is possible.

Campbell warns there are things to keep in mind about these companies that don't normally apply to U.S. stocks. Typically, they are the largest commercial enterprises in a given country and act like lightning rods in times of political or economic upheaval. Hong Kong Telecommunications' fate rests on how things work out when China takes back the British colony in 1997.

Also with the overseas companies, accounting differences can be difficult to sort out. Teléfonos' earnings, for example, are adjusted for the effects of inflation. There is foreign currency exposure, too, to consider.

Don't be fooled into thinking that rapid growth always signals a good investment, says Campbell. Philippine Long Distance Telephone Co.'s revenues have almost doubled since 1984, to $374 million, thanks to improved service and greater market penetration. But it has a long way to go. It has just 1 access line per 100 people, versus 42 for the U.S. To catch up, it has had to borrow heavily and is stuck with a troubling 57% debt-to-equity ratio. High interest costs on that debt have kept shareholders from participating fully in earnings growth.

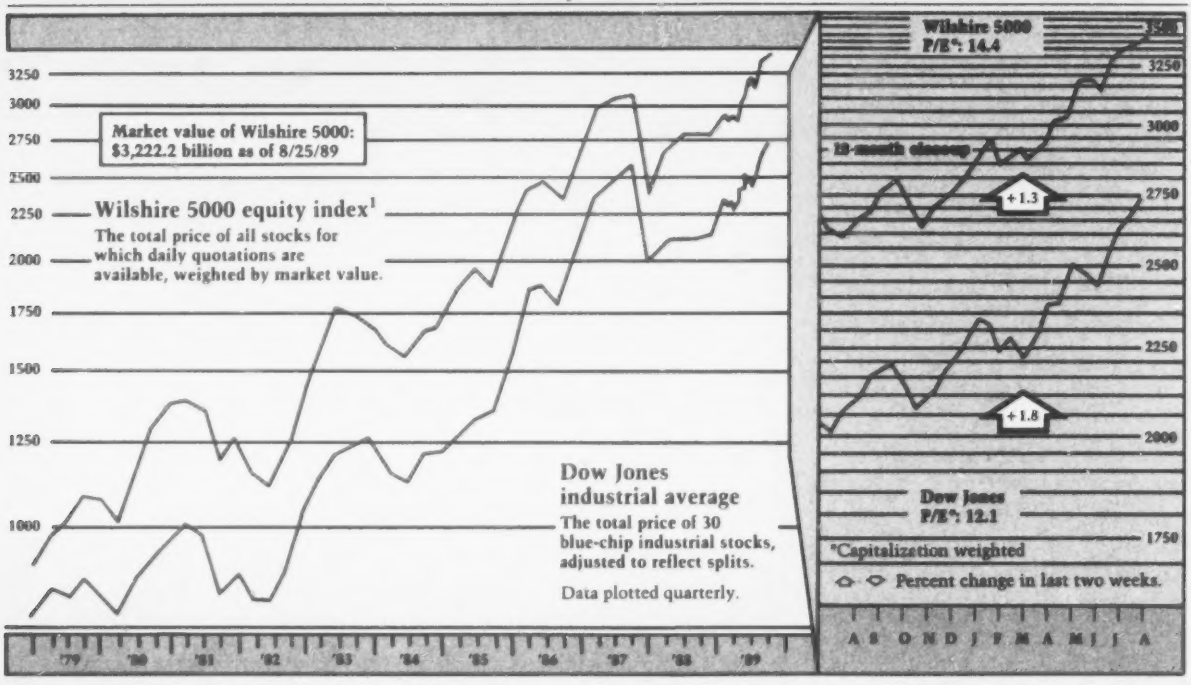
At the other extreme, technologically up-to-date phone companies tend to be overpriced. Nippon Telegraph & Telephone Corp. sells at 110 times projected earnings (foreign investors can't own it anyway, for now). Also at a premium is U.K.-based Cable & Wireless, which owns 70% of Hong Kong Telecom.

There will be more choices in the years ahead. Phone companies in Australia, Korea, Portugal and Singapore, to name a few, are candidates to go public, Campbell feels, as governments unload their stakes and more capital is needed for expansion.

"There are good bargains here because markets abroad are less efficient than ours. As global consciousness grabs us, that will change," he says. "These are global consciousness stocks." ■

The Forbes/Wilshire 5000 Review

Edited by Steve Kichen


Market value of Wilshire 5000: $3,222.2 billion as of 8/25/89
Wilshire 5000 equity index[1]
The total price of all stocks for which daily quotations are available, weighted by market value.
Dow Jones industrial average
The total price of 30 blue-chip industrial stocks, adjusted to reflect splits.
Data plotted quarterly.
Wilshire 5000 P/E*: 14.4
12-month closings
+1.3
+1.8
Dow Jones P/E*: 12.1
*Capitalization weighted
Percent change in last two weeks.
A S O N D J F M A M J J A

Then and now. In the last 12 months stock prices recovered sharply from the October 1987 crash. The Dow industrials are up 35%, while the overall market, as measured by the Wilshire index, shows a 32% increase. It is now clear that the present market is not following in the footsteps of the post-1929 market. Measured by month-end closes, the Dow index peaked in August 1929 at 380. Exactly two years later it was priced 63% lower. In fact, it took the Dow more than 25 years (until November 1954) to produce a month-end close above the August 1929 value.

During the last two weeks the Dow industrials finally surpassed their August 1987 precrash peak of 2722 and finished the two-week period at 2732, just two points short of the new high hit on the previous trading day. The Nasdaq index ended the two-week stretch at its highest point ever. The Wilshire index of nearly 6,000 issues shows a 1.3% gain for the two-week period.

Closeup On the Equity Markets

Performance of six leading indexes

Percent change	Wilshire 5000	Forbes 500[2]	Dow Jones industrials	NYSE Composite	Amex Market Value Index	NASDAQ Composite
in last 4 weeks	2.6	2.5	3.7	2.3	1.8	3.1
in last 52 weeks	32.1	31.7	35.4	32.3	29.7	24.7

Stock performance based on six key investor variables[3]

Percent change	Company size		Volatility[4]		P/E multiple		Dividend yield		Growth profile[5]		Share price	
	large	small	high	low	over 22	under 8	over 4.2%	none	high	low	over $36	under $5
in last 4 weeks	3.2	2.6	2.4	2.3	1.9	4.6	2.0	1.6	2.5	1.9	3.2	1.3
in last 52 weeks	35.4	30.1	21.8	29.1	33.5	23.5	11.4	28.0	27.1	23.5	35.1	12.3

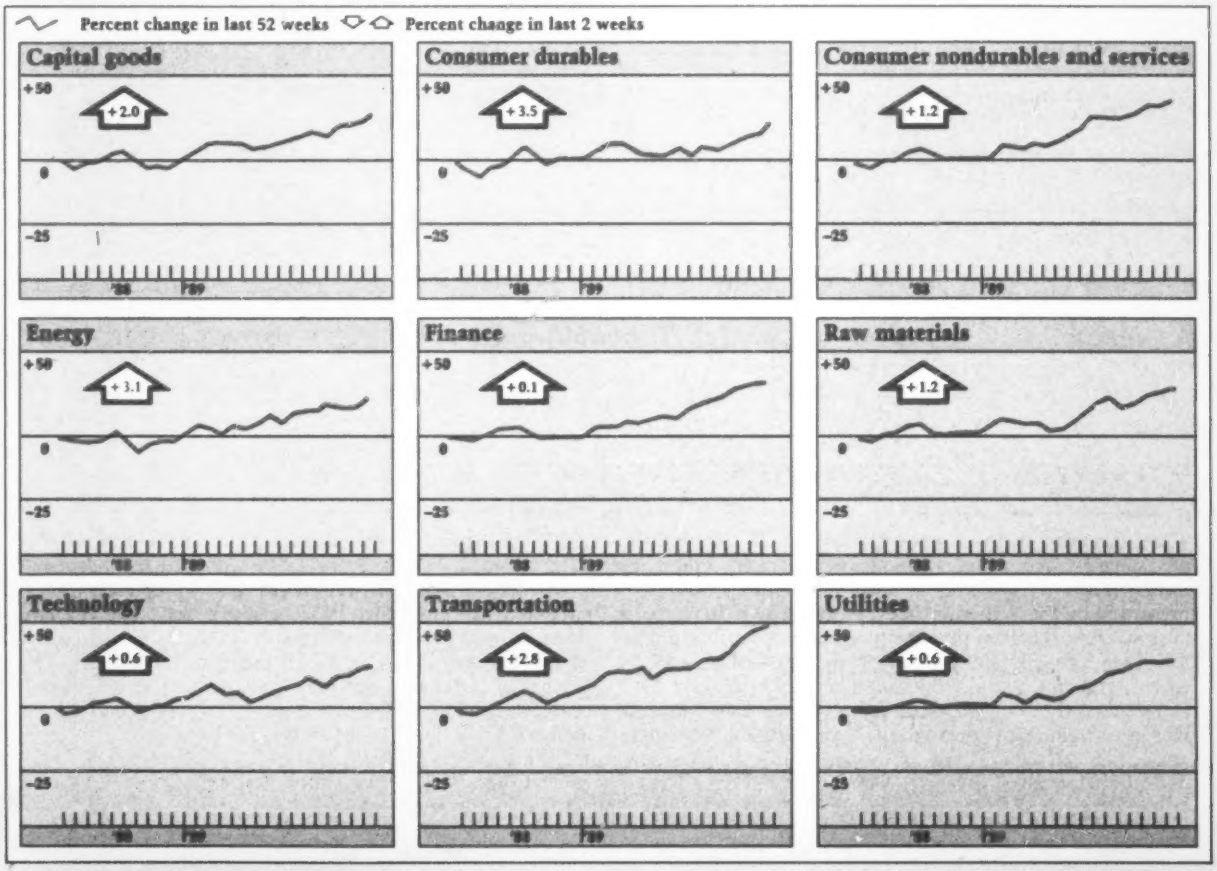
[1]Wilshire index reflects price performance. It differs slightly from market value of outstanding stocks because of retirements of equity since index was created. [2]Based on sales. [3]Equal weighted indices containing all shares with market capitalizations over $10 million. [4]A stock's sensitivity to overall market movement. High-volatility issues have wide price fluctuations, low-volatility issues are more stable. [5]A quantitative evaluation of a stock's growth image, determined by Wilshire Associates.

Note: All data for periods ending 8/25/89. Prepared by Wilshire Associates, Santa Monica, Calif.

Steven Ramos

Where the Action Is

Takeover plays and new rumors helped push stocks to record levels during the last two weeks. The consumer durables sector posted the best gain, a jump of 3.5%. The sector was led by rumblings that a bid would be made for Maytag, which rose 13%. In the consumer nondurables sector, Lyphomed, a Rosemont, Ill. pharmaceutical company, rose 42%, to 30⅛. Fujisawa Pharmaceutical, which already owns 30% of Lyphomed, wants to buy the remaining stock at $31 per share. In the same sector, Tiffany & Co., a retailer of jewelry, rose 25% amid takeover speculation and the release of improved quarterly results. Texas Air, with a 24% gain, led the transportation group. The carrier announced it was considering an offer to sell a stake in Continental Airlines, reportedly to SAS.



What the Analysts Think

Prices rise, estimates fall. Analysts cut 1989 earnings estimates for all nine Wilshire sectors. In our previous report finance stocks had the smallest estimate cuts, while in the last two weeks estimates for this group were cut the most. Grubb & Ellis, Farm & Home Financial and First Tennessee National show some of the sharpest cuts.

Forecasting the Forbes Sales 500

Performance period	Average earnings per share	P/E
latest 12 months	$3.33	13.9
1989 estimates	3.65	12.7
1990 estimates	4.00	11.6

Rank based on change in estimate	Sector	Estimated 1989 EPS	Estimated 1989 P/E	% change in 1989 estimate in 2 weeks	% change in 1989 estimate in 4 weeks
1	Utilities	$2.95	12.5	-0.15%	-0.35%
2	Consumer nondurables	2.54	14.8	-0.33	-0.64
3	Raw materials	3.38	10.5	-0.60	-1.11
4	Capital goods	2.97	14.5	-0.70	-1.28
5	Consumer durables	3.37	12.1	-1.05	-1.60
6	Technology	2.99	12.8	-1.16	-2.83
7	Energy	3.50	12.7	-1.26	-2.10
8	Transportation	2.41	14.0	-1.91	-2.60
9	Finance	3.34	10.8	-3.70	-3.88

Earnings projections are capitalization-weighted consensus estimates from over 3,000 security analysts. Data are compiled and updated continually by the Institutional Brokers Estimate System (IBES), a service of Lynch, Jones & Ryan, a New York-based brokerage firm.

Note: All data for periods ending 8/25/89. Prepared by Wilshire Associates, Santa Monica, Calif.; IBES, a service of Lynch, Jones & Ryan, New York.

Housing is likely to be a buyer's market for at least another year. Here's why.

DOWN BUT NOT OUT

By Charles E. Babin

In my FORBES column of Sept. 9, 1985, I predicted the Reagan-era tax initiatives would deal a blow to the nation's home builders and mortgage lenders. With the phasing in of tax cuts, the subsidy to home ownership eroded and the housing sector languished. A recovery is at least a year away.

House prices are linked to the aftertax cost of home ownership, and this cost has climbed as marginal tax rates have been reduced. When marginal rates reached 70%—the top rate when Reagan took command in 1981—the government subsidized the lion's share of housing costs because they were largely tax-deductible—especially during the early years of the mortgage.

The reverse also holds. If marginal tax rates drop, the government's share of housing costs falls while the homeowner's increases. Thus does tax policy affect the affordability of housing.

For the typical home buyer, the 1986 tax package had a double-barreled effect. The number of tax brackets was cut from 14 to 3 and inflation indexation was introduced. These significantly reduced the pace at which taxpayers were pushed into higher tax brackets. Second, the top marginal rate was cut from 50% to 33%. The cumulative impact was to increase materially the aftertax cost of home ownership. Whereas the overall economy advanced at a robust 3.7% pace in 1987 and 4.4% in 1988, residential investment fell in both years.

In 1989 the problems have persisted. And now, given the scale of the S&L debacle, even sound development could find it tougher to secure construction loans.

The table below reveals the magnitude of this tax effect and updates the calculations that were presented here four years ago. Notice that from 1975 through 1980—a period when there were no statutory changes to the tax system—there was no change in the aftertax affordability of home ownership. Aftertax housing costs as a percentage of aftertax income was 10.5% in 1975 and 10.6% in 1980. Yet during this period the average home price climbed 85%, interest rates increased 50% and property taxes doubled. This was affordable because the tax subsidy increased dramatically as the family marginal tax rate shot up from 34% in 1975 to 49% in 1980.

But by 1985, after the first round of phased-in tax cuts, the ability of the hypothetical family to afford a home fell, as the marginal tax rate dropped back to 38%.

Now there's a new setback: The economy is slowing. Should a recession occur, housing will probably be hit hard. Potential home buyers, worried about job security, can be expected to put off buying a house. So, despite improvement in the affordability formula, recovery in housing may be postponed.

Notice I said "postponed." There is a direct relationship between interest rates and housing activity. If history's a guide, early indications suggest that today's lower interest rates will benefit the economy in 1991, with a leaner, more competitive housing industry leading the pack. If so, there may well be exciting investment opportunities, the most likely candidates being the financially sound and well-managed home builders. ■

Charles E. Babin is managing director of BRS Capital Management, Inc., an investment management firm, in Boston.

Home affordability

Lower marginal rates are great for taxpayers, but they do make housing less affordable. By lowering the value of deductions, the Reagan tax cuts have raised the fraction of aftertax income needed to pay for a house.

	1975	1980	1985	1988
Average home price[1]	$39,000	$72,800	$90,800	$112,800
less: 25% down payment	–9,750	–18,200	–22,700	–28,200
equals: mortgage amount	29,250	54,600	68,100	84,600
Initial-year payments				
interest[2]	2,624	7,439	8,514	8,736
real estate taxes[3]	975	1,820	2,270	2,820
less: tax savings[4]	–1,224	–4,537	–3,901	–3,162
equals: aftertax interest and real estate tax cost	2,375	4,722	6,883	8,394
plus: principal payments	200	138	221	437
equals: aftertax housing costs	2,575	4,860	7,104	8,831
Gross income	29,635	56,808	60,000	80,902E
less: tax liability[4]	–5,000	–11,150	–8,820	–13,137
equals: aftertax income	24,635	45,658	51,180	67,765
Aftertax housing cost as a % of aftertax income	10.5%	10.6%	13.9%	13.0%

[1]Figures from National Association of Realtors. [2]Figures from Federal Home Loan Bank Board. Approximate 30-year fixed-rate: 1975 = 9.0%; 1980 = 13.64%; 1985 = 12.52%; 1988 = 10.35%. [3]2.5% of market value. [4]Imputed from appropriate-year tax tables. E: Estimate.